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Asia's Economic Crisis and the IMF

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Abstract:
In 1995, the IMF predicted that "miracle economies" in Asia were vulnerable to the same kind of financial crisis that ravaged Mexico the year before, but most Asian countries scoffed at such dire predictions. Now those countries are looking to the IMF to bail out their economies. Most analysts agree that the IMF's bitter medicine is resuscitating Thailand and South Korea.

Full Text:

In July 1995, at one of their public forums, senior policy-makers at the International Monetary Fund (IMF) surprised many observers when they asserted that the 'miracle economies' of South-east and East Asia were vulnerable to the same type of financial crisis that had ravaged the Mexican peso in December 1994. The IMF officials argued that, despite the Asian tigers' seemingly sound macro-economic fundamentals, disturbing signs of disequilibrium were looming for a number of the region's 'star performers', in particular, Indonesia, Malaysia, the Philippines and Thailand, and, to the surprise of many, the world's eleventh largest and the most miraculous of Asia's miracle economies - South Korea.1

The problem, they argued, could be explained by basic macro-economics: an imprudently large and growing current-account deficit (the trade balance plus interest payments on foreign debt), financed increasingly by short-term capital inflows; a rapidly rising external debt; deteriorating international competitiveness (partly the result of formal and informal pegging of regional currencies to the rising US dollar); lack of financial transparency in government-private-sector financial relations; an under-regulated, poorly capitalised and over-exposed banking system; and, most troubling - especially in Thailand and Indonesia (and, to a lesser extent, South Korea) - the rising share of capital investments flowing, not to enhance export-promotion in knowledge or value-added manufactures and high-technology industries, but in highly speculative and overvalued property ventures financed largely with unhedged short-term borrowing in foreign currency. During the latter part of 1995 and throughout 1996, several senior IMF officials, including Deputy Managing Director Stanley Fischer, repeatedly alerted the governments of Indonesia, Malaysia, Thailand and others to these risks. They urged them to implement corrective measures - such as deep budgetary cuts, tax hikes and greater transparency in economic relations - to avert an impending economic crisis.

The IMF's diagnoses and prescriptions were prophetic. But, as often happens, governments blinded by euphoria postpone dealing with still-diffuse problems. The Asian tigers ignored the IMF's caution and are now paying the price. Paradoxically, their road to economic recovery will now be determined by how diligently they take the IMF's medicine. If they fail to do so, their economies will remain in trouble, causing severe social, political and even security problems for the region.

The Asian Tigers' Denial

Without exception, Asia's governments were impervious to the IMF's exhortations. Some publicly scoffed at the IMF's 'apocalyptic' projections and policy prescriptions, adopting at best only minor, if not largely cosmetic, economic reforms.2 Thailand's former Prime Ministers, Banharn Silpa-archa and Chavalit Yongchaiyudh (the General who replaced Banharn in November 1996), and their advisers seem to have never fully understood the country's severe underlying monetary and financial problems.3 They dismissed Thailand's large external deficits and asset price bubbles as 'temporary', and zero export growth as primarily 'cyclical', reflecting potentially reversible factors such as weak demand in Europe, Japan and the US. Finding comfort in Thailand's high savings rate, a government budget surplus and dexterity in overcoming economic volatility in global financial markets, plus the Bank of Thailand's successful defence of the bal:t against the first wave of the 'tequila effect' in January 1995, and the premier Bangkok Bank's unprecedented 30%-plus return on equity in 1995-96, the authorities claimed that all was 'fundamentally sound' with the Kingdom's financial sector.4 Chavalit, who continued to promise the IMF a 'dream team' of economic managers to implement reforms, became a master in sending mixed messages to the IMF team in Bangkok (there at his government's request), and dithered for months over minor technical policy issues, until the crisis broke and he was forced out of office in November 1997.

While Indonesian President Suharto, the self-styled 'Father of Development', remained aloof, Bank Indonesia Governor Soedradjat Djiwandono informed the IMF that Indonesia would seriously consider the IMF's recommendation to implement corrective measures. In the end, Jakarta only widened the fluctuation band for the rupiah against the US dollar in early 1997. While this allowed for a gradual depreciation of the riipiah (by some 4-5% per year from mid-1995-97), and prevented the emergence of serious exchange-rate distortions, it failed to deal with Indonesia's weak-spot: lax financial regulation and mushrooming private foreign debt. However, neighbouring Malaysia's long-time Prime Minister Mahathir Mohamad considered the IMF's comparison of his region with Latin America as irresponsible and simplistic. Mahathir, backed by his former economic adviser Daim Zainuddin, lashed out, claiming that, unlike Mexico's current-account deficit (financed by short-term foreign-portfolio investment), Malaysia's deficit was financed by long-term foreign-capital inflows used for business investment rather than government or consumer profligacy - hence eliminating the potential for sovereign default risk. Mahathir conveniently forgot to acknowledge that Malaysia's manufacturing export boom of the 1980s was now facing severe slow-down as the result of falling competitiveness, rising wages (which had increased by 11.4% in 1996-97), stagnant productivity (which managed only a 1.4% gain), and high ratios of foreign debt to gross domestic product (GDP) in conjunction with other factors, it reduced competitiveness and increased inflation.5 Moreover, Malaysia's growing list of extravagant projects - such as the Bakun Dam (Asia's largest hydro-electric dam, costing an estimated $5.7bn), Kuala Lumpur's showpiece, the world's tallest building ($0.75bn), a super-modern airport ($3.4bn), a new administrative capital for Sarawak in Borneo (over $3bn) and a $7.6bn national administrative capital, all requiring heavy imports of capital and technology - was inexorably pushing the current-account deficit higher.

Although Mahathir correctly pointed out that Mexico's currency crisis was fundamentally a short-term 'monetary management problem', he incorrectly attributed the sudden and massive speculative attack on the peso exclusively to Mexico's political instability brought on by the assassination of the presidential candidate, Luis Donaldo Colosio, and by the regime's inability to contain violent protests in Chiapas. Mexico, Mahathir declared, held no real lessons for Malaysia, and the IMF's stabilisation prescriptions were inappropriate for his country and for members of the Association of South-east Asian Nations (ASEAN) as a whole. Yet Mahathir, aware of his country's growing currentaccount deficit, announced in September 1995 that the government would implement a series of stabilisation measures - in line with what the IMF had been urging. In late 1995, the government introduced its 'home-grown' plan, which included scaling down some of its ambitious 'mega-projects' and a series of anti-speculation measures to cool off the overheated property market.6 In late 1995, Bank Negara, Malaysia's Central Bank, was instructed to maintain a tight monetary policy. Under the new tight liquidity, the ringgit was allowed to appreciate to neutralise the impact of short-term capital inflows and to insulate the economy from imported inflation.7 These last-minute reform measures ultimately enabled Malaysia to weather the 1997 crisis.

The Asian Paradox: The Price of Success

The Asian governments' 'denial syndrome' is understandable. The region's 'miracle economies' have long been viewed as a model for others to emulate. Between 1965 and 1990, the economies of Japan, the four original tigers (Hong Kong, Singapore, South Korea and Taiwan) and the three emerging South-east Asian tigers (Indonesia, Malaysia and Thailand) grew more rapidly and more consistently than any other group of economies in the world, averaging 7% peryear growth in real terms since the mid-1970s, and 9% per year in the 1990s. All these economies experienced dramatic increases in real per-capita incomes. In South Korea and Singapore, for example, real per-capita income grew by more than 700% between 1965 and 1995. Over the same period, Taiwan and Hong Kong saw more than a 400% increase, while Indonesia, Malaysia and Thailand each experienced real per-capita income growth of over 300%.8

South Korea's unprecedented growth in per-capita gross national product (GNP) - 6.9% in 1960-81 and 8.5% in 1980-94 - increased incomes from $1,700 in 1981 to $8,260 in 1994. Equally impressively, Indonesia's per-capita GNP rose from $90 in 1972 to $880 in 1994, Thailand's rose from $220 to $2,410 and Malaysia's from $450 to $3,480 during the same period. While there are country variations, overall, the benefits of this growth have extended to all sectors of society. In Thailand, for example, poverty has been reduced from over 57% in the late 1960s to about 13% in 1996, with Thais enjoying dramatic improvements in social welfare. Similarly, in Indonesia, despite remaining disparities, the benefits of growth have covered all of its 27 provinces. Between 1970 and 1996, the proportion of the population living below the official poverty line declined from 60% to an estimated 11%. The average Indonesian's quality of life has improved greatly: infant mortality declined from 145 per 1,000 live births in 1970 to 53 per 1,000 in 1995; life expectancy rose from 46-63 during the same period, and the country achieved universal primary education in 1995.

A common practice among market-guided developing economies is to peg their exchange rates to encourage trade and investment, to anchor domestic prices, and to signal their commitment to prudent monetary policies. The formal pegging of the Thai baht, Malaysian ringgit, the Philippine peso and other regional currencies to the US dollar had provided a strong impetus to **exportled growth**. The mid-1980s' Asian export boom was driven largely by the depreciation of the US dollar in relation to other countries and by the fact that currencies such as the baht were pegged to it. This pegging made Thai exports more competitive internationally. It also prompted a massive influx of Japanese, Taiwanese and Hong Kong investment into these emerging Asian economies because these countries wanted to avoid rising domestic labour costs. Not surprisingly, in Thailand, the terms of trade improved, and the economy recorded a GDP growth-rate of 12% a year between 1987 and 1990, and

8% growth between 1991 and 1995. Thailand's exports from manufacturing rose from 35-80% of total merchandise exports, the largest percentage of any ASEAN country. From 1994-96, ASEAN and East Asia recorded the highest rates of increases in merchandise trade. The region's imports rose by 15.6% and reached $1.01 trillion. Exports from Asia rose by 15.2% to $1.ltr, and Asia, which controlled 17% of the world's GDP in 1950, saw its share jump to around 40% by 1997. The World Trade Organisation (WTO) pointed out the ascendance of the six most dynamic Asian trading spots: Hong Kong, Malaysia, Singapore, South Korea, Taiwan and Thailand. In these countries, exports were up by 18.1% to $418 billion, a 9% increase over 1993-94.10

By early 1996, a measure of financial stability was restored after the contagion effects of the Mexican peso crisis had subsided and bravado had returned to Asia's capitals. Caution had been lost as governments took solace in the fact that they belonged to that most exclusive of clubs, what the World Bank had labelled the 'High Performing Asian Economies'.ll A spate of popular books and academic tomes projected the inexorable shift in power towards the `Asia-Pacific' and showered praise on the virtues of East Asian-style stateguided capitalism.2 Not surprisingly, the region's self-styled gurus, such as Mahathir and Singapore's senior leader, Lee Kuan Yew, found the imagery of 'Asian-style capitalism' congenial - it endorsed the hegemony they deemed necessary to their leadership role. In a world where these gurus are held in awe, they confidently asserted that Asia had defied doomsayers before and that the region's exuberant growth was destined to continue well into the next millennium. A growing number of distinguished economists, including Columbia University's Jagdish Bhagwati, concurred with the sanguine assessments.'3 East Asia's economic growth, they reasoned, was due to its faithful adherence to the neo-liberal or market-friendly model known as 'the Washington consensus'. By maintaining liberalised trade and foreigninvestment policies, a single competitive exchange rate and a commitment to the principles of comparative advantage, economic integration and **export-led growth**, Asia was able to build an economy on solid foundations: in other words, an economy based on both the accumulation of factors of production (especially the massive investment in physical capital) and increases in total factor productivity, measured in terms of improvements in technology and efficiency."

It is not that the 'optimists' were wrong in their assessment of the East and South-east Asian economies; rather, they failed to factor in the IMF's caution that the high-performing Asian economies (like Mexico in 1994) were also vulnerable to severe financial shocks, in part because of their success. What accounted for this paradox? The answer lies in the nature of global financial markets and their links with high-performing emerging economies. While the onset of the debt crisis in 1982 saw a sharp decline in capital inflows to developing countries - from $30bn in 1997-82 to under $9bn in 1983-89 - the liberalisation of cross-border financial transactions and the progressive integration of global capital markets in the 1990s witnessed a dramatic revival and expansion in capital inflows to developing countries. From 1990-94, 'capital surges' to developing countries leapt to $104.9bn, with a disproportionate share going to the high-performing Asian economies. They received some $52.lbn, or 50%, of the total capital flows. The 'ASEAN 4' of Indonesia, Malaysia, the Philippines and Thailand alone experienced money and credit growth rates of 25-30% a year from 1992 to the end of 1996."

What was significant about the new surge was the sharp rise - in terms of both absolute levels and the share of total outflows - in short-term portfolio capital flows. For developing countries as a whole, aggregate private capital flows increased from $6.6bn from the base years 1983-89 to $154bn in 1993 to roughly $167bn by 1996.'6 Portfolio capital flows consisting of international placements of tradable bonds, issues of equities in international markets and purchases by foreigners of stocks and money-market instruments (in particular, securities and mutual funds) in high-performing developing economies domestic markets can greatly benefit emerging economies by fostering financial integration and improving the returns on investments through a knowledge and skills exchange, enhanced competition and market-efficiency effects. However, short-term private capital inflows can be destabilising, especially if they are large relative to GDP. Short-term capital inflows that often show up as an expansion in liquid short-maturity bank deposits are highly sensitive to cyclical fluctuations in domestic or international interest rates. Thus, short-term portfolio capital flows exhibited high volatility, with sudden outflows potentially resulting in a balance-of-payments problem or widespread financial crises. The absence of prudent management can make surges in capital flows produce an appreciation of the real exchange rate, an inflationary expansion of domestic money and credit, and an unsustainable current-account deficit. Moreover, the unpredictable movement of international portfolio capital can wreck an economy that has grown too dependent on it. Given the fact that portfolio investments are usually liquid financial instruments (and, under liberalised foreign-exchange controls, easier to move in and out of a country), it constantly chases and demands prohibitively high 'enticements' or high rates of return and engages in risk diversification. This can make emerging economies - especially those with limited absorptive capacities, weak fiscal policies, poorly managed banking systems, weak prudential surveillance and distorted domestic markets - highly susceptible to volatility, including large reversals in capital flows. Such a case was already evident in early 1994: when the US Federal Reserve began to increase interest rates, the international portfolio investors' appetite for emerging markets stocks and bonds greatly diminished, contributing considerably to the Mexican peso crisis. With the exception of Hong Kong, Singapore and Taiwan, the high-performing Asian economies all suffered from these economic flaws.

In addition, the increased 'dollarisation' of these national economies enabling non-resident portfolio investors to participate in bond flotations - also carried an in-built credit and exchange-rate risk, as did the burgeoning number of domestic banks borrowing abroad in short-term dollar-denominated securities and then lending to finance domestic projects based mainly on longer-term projected higher returns.lv For example, in Thailand and Indonesia, the authorities, in permitting the development of serious asset liability mismatches in the banking sector, contributed to the proliferation of undercapitalised and under-regulated banks without the capacity to put capital resources to productive use. These 'quasi-banks' or 'financial trusts', lacking system-wide portfolio diversification, by acting as intermediaries for channelling vast sums of foreign capital into the domestic economy, had every incentive to borrow abroad and lend and 'invest' domestically with abandon. However, by engaging in such practices, they exposed themselves to the risk of currency depreciation since the value of such loans would fall relative to the value of their dollar borrowing.

So why did these financial intermediaries engage in - and get away with such risky practices? In short, most of the 'trusts' controlled by the ruling elites and their cronies - selected on the basis of nepotistic, factional and personal ties - provided an avenue for these groups to distort resource allocation (to property and consumption), and to appropriate large sums of 'easy money' through a complex and pervasive system of corruption. For instance, if the lending worked for the owners of these 'trusts', the 'bankers' made a quick profit. If, however, lending and debt repayments failed, the depositors and creditors lost money. The unaccountable, and often unidentified, bank owners with little capital tied to the bank simply walked away without fear of punishment. Under such conditions, even solvent and otherwise healthy banks are vulnerable to liquidity problems, especially when short-term interest rates suddenly rise for a sustained period. The need to roll over the short-term liabilities can - and did - seriously undermine these banks' income position.

In Indonesia, Malaysia, Thailand and, to a lesser extent, the Philippines, the situation was further exacerbated by lack of investor confidence, given the almost total lack of transparency in banking operations; the maintenance of an overvalued real exchange rate; and the channelling of foreign capital inflows into overvalued non-tradeable sectors - property in particular. Meanwhile, the tradeable sectors necessary to provide the resources for future debt servicing were generally by-passed. Under these economic circumstances, the Thai government's insistence on maintaining a pegged currency regime (instead of a devaluation-immune fixed exchange rate), was an invitation to a speculative currency attack. This is what happened to some members of the European Exchange Rate Mechanism in 1992 and 1993, Mexico in 1994 and the Czech Republic in 1997. And this is precisely what happened to the high-performing Asian economies in summer 1997.

Summer 1997: The Deluge

Thailand

By April 1997, Thailand's economy stood on the edge of a precipice. Its engine, export growth, had slowed markedly, not only in the primary commodities and labour-intensive sectors such as clothing and textiles, but also in the electronics sector, where labour costs were three times higher than those in similar plants in Shanghai. While the slow-down was caused by increased competition from lower wage- and production-cost new entrants like China, India and Vietnam, it was also due to the in-built inefficiencies of its economy.

However, the real cause of this sudden slow-down in export growth was fixed exchange rates. Under this system, capital inflows to purchase Thai securities or to expand manufacturing capacity in Malaysia or Indonesia required that their Central Banks buy dollars and supply baht, ringgit or rupiahs, creating a glut in the money supply. Central Banks' efforts to offset these flows (most commonly by selling government securities), raised domestic interest rates and fuelled further capital inflows, eventually making these countries' exports relatively costly on world markets. Compounding this was the 1994 devaluation of the yi<an, which made China more competitive, and the appreciation of the US dollar against the yen (a 40% rise from 1995-96), and against European currencies, inadvertently making the dollar-pegged baht and other South-east Asian currencies artificially strong. This in turn made exports from these countries more expensive and less competitive. Since the Thai authorities refused to let the baht adjust to the rise of the dollar, the only way it could maintain its ten-year stable peg (25 baht per dollar) was to raise domestic interest rates to unsustainably high levels. This rise affected the property and banking sectors - property developers could not pay back their loans, and many banks stuck with fast-growing non-performing loans witnessed a sharp deflation in the value of their assets.' By April 1997, Thailand's real exchange rate had considerably appreciated and equity prices were plummeting. With the current-account deficit running at an abnormally high 8.5% of GDP and financed increasingly by short-term inflows, gross external debt rose to $70bn (of which $40bn was short-term loans) or approximately 50% of GDP. These problems exposed other weaknesses in the economy, including substantial unhedged foreign borrowing by the private sector, unsustainable domestic consumption, a grossly inflated property and stock-market, and weak and over-exposed financial institutions - many of whose solvency was now in question.

During 14-17 May 1997, the baht came under relentless speculative pressure as financial markets - in particular, currency speculators - concluded that its pegged exchange rate was unsustainable given the country's large currentaccount deficit, high short-term foreign debt and declining competitiveness. The Thai authorities' desperate efforts to maintain a fixed exchange rate for the baht (via capital and exchange controls and interest-rate hikes) - especially those of Finance Minister Amnuay Viravan - proved futile and exacerbated the costs to the Treasury. Within weeks, volatile speculation consumed most of Thailand's hard-earned foreign-exchange reserves - which fell from $37.7bn in December 1996 to under $10bn on 14 August 1997. On 2 July, the Bank of Thailand bowed to the inevitable and introduced a more flexible exchange-rate regime, floating the baht, thereby replacing a basket of currencies which depend heavily on the US dollar.l9 Almost immediately, the beleaguered baht depreciated by a cumulative 20% (plummeting to a record low of 28.80 to the dollar), as investors - including domestic corporations - scrambled to buy foreign exchange. As domestic corporations who had borrowed heavily in foreign currencies realised that the peg might not hold and that their debtservice costs might rise, they did everything possible to sell domestic currency, extending the currency free-fall. By early September, the baht had dropped to 38 to the dollar - a fall of 32%.

The Thai government's indecisive policy responses further shook market confidence. Amidst evidence of growing market contraction, the authorities' reluctance to close insolvent financial institutions and tighten monetary conditions, and the rapid reverberations of the financial contagion in Hong Kong, Indonesia, Malaysia, the Philippines and South Korea - including the moderate weakening of the strong Singaporean and New Taiwanese dollars panicked the already jittery market.zo Domestic investors seeking to hedge their foreign-currency exposures were now forced to scrutinise the region's underlying economic problems. Market doubts were compounded by the general lack of transparency and inadequate and unreliable information. More importantly, international commercial and investment banks, mutual fund managers, securities firms, stockbrokers, portfolio investors, currency traders and others in competitive marketing-sales - whose voracious appetite for commissions had led them to oversell Asia's emerging economies - were also now forced to reconsider the region's underlying economic problems. What they saw - to different degrees in different economies - were many of the same problems. When it became apparent to foreign creditors that Thailand (and maybe others) had more short-term foreign debts than remaining short-term foreign reserves, a 'stampede' ensued.

To the government's consternation, its urgent appeals for Japanese assistance were rebuffed (despite Japan's considerable financial stake in the country), and it was forced to ask the IMF for technical assistance on 28 July to forestall a balance-of-payments crisis.21 A stand-by adjustment programme was agreed in early August 1997, which provided the basis for a $17.2bn emergency international financing 'bail-out' package.zZ The Thai authorities agreed to swallow the IMF's medicine and unveiled an austerity plan (the '1997-2000 Program'), immediately suspending 48 finance firms and providing a blueprint to restructure the financial sector. The core of this Program are the 'secondgeneration' reforms designed to re-establish domestic and external confidence in the country's financial system by requiring that 'surviving' banks meet tough reserve and supervision requirements. These requirements include a tight monetary policy to stop authorities from printing money in order to 'rescue' failed or failing financial and property companies. This measure was to be complemented by several belt-tightening measures, such as expenditure cuts, shifts in domestic savings-investment balances to reduce the external current account deficit to a more sustainable 5% in 1997 and 3% of GDP in 1998, and maintaining GDP growth at 3-4% and capping year-end inflation at 9.5% in 1997 and 5% in 1998. State enterprises were also required to maintain their financial balance by phasing out low-priority investments and seeking privatesector participation in infrastructure programmes, and the government was ordered to reduce its budget deficit by January 1998 through increasing the rate of value-added tax (VAT) from 7-10%, as well as cutting fiscal spending by 100 million baht.

The IMF's bail-out of Thailand failed to stop the financial contagion in the region. Not only did the baht's fall immediately raise doubts about the viability of exchange-rate arrangements in neighbouring countries, but Thailand's neighbours failed to take the warning signs seriously. Singapore's Prime Minister Goh Chok Tong dismissed the crisis as `merely a hiccup'; President Suharto's public statements implied that Indonesia had decided to reject financial assistance from the IMF (although an IMF team was in Jakarta, negotiating a rescue package), and would instead accept a $10bn assistance package from 'friendly neighboring Singapore'. Mahathir alleged that a Western conspiracy was trying to undermine developing countries and declared that 'the free exchange of currencies is unnecessary, unproductive and immoral' and 'should be made illegal'.23 After these statements, the ringgit fell by 4% in less than two hours to a low of 3.4080 to the dollar. Indeed, by midOctober, the cumulative declines of the ASEAN 4 currencies against the dollar exceeded 30% for Indonesia and Thailand and 20% for Malaysia and the Philippines.

Indonesia

As noted earlier, Indonesia weathered the initial wave of currency turmoil reasonably well. Its wider trading band for the rupiah (from 8-12%) against the dollar allowed the rupiah to depreciate gradually and prevented any serious exchange-rate distortions. However, the rupiah could not escape the second wave of currency attacks in late July, dropping 6% in a day to 2,510 to the dollar. Despite Bank Indonesia's efforts to curb a possible currency and stockmarket meltdown by cutting interest rates by 50 basis point on 8 August, and by 100 basis point on 13 August - including selling an estimated $200m of its foreign reserves - it could not stop the currency attack or the continued fall of the rupiah - which stood below the 2,682 rupiah to the dollar floor of the intervention band by 13 August. On 14 August, Bank Indonesia abolished the system of managing the exchange rate through the use of the currency band, and let the rupiah float. This action triggered an immediate plunge in the rupiah to 2,830 to the dollar (settling at 2,960 on 31 August); stocks fell from 720 in early July to below 600 by 20 August.

The rupiah's downward spiral cannot be attributed simply to regional contagion. Rather, currency and stock traders, including Indonesian corporations (now desperately selling riipiah and buying dollars), could no longer ignore the long overlooked, yet open, secret about the Indonesian economy - pervasive corruption. Specifically, the government's accounting irregularities and unauthorised expenditures, the widespread misappropriation of public funds by the politically well-connected and pervasive mismanagement of the economy by Suharto's family and cronies created uncertainty about the nature and extent of the country's private foreign debt. Even Bank Indonesia lacked the regulatory powers to force politically wellconnected banks and 'financial trusts' to disclose details about their operations, including their levels of off-shore debt. Not surprisingly, while Bank Indonesia placed the country's private foreign debt at around $55bn, financial-market analysts placed it at over $100bn.21 Moreover, much of the debt was unhedged borrowers had failed to protect themselves against a possible fall in therupiah. Indeed, as the rupiah fell against the dollar, the unhedged dollar-denominated loans now cost over 30% more to service. The loss of investor confidence intensified the attack on the rupiah - it fell to about 3,850 to the dollar by late September - a 34% decline since August. On 8 October, Jakarta approached the IMF and the World Bank for assistance. On 5 November 1997, the IMF, with the World Bank and the Asian Development Bank (ADB), approved a $23bn multilateral financial-assistance package for Indonesia to restore confidence and stabilise therupiah Indonesia also had to accept the IMF's bitter medicine and agree to maintain tight fiscal and monetary policies designed to stabilise financial conditions and reduce the current-account deficit. The government also agreed to 'immediately close' 16 unviable banks, while weak but viable banks were required to formulate and implement rehabilitation plans. Indonesia was also asked to adopt measures to strengthen the legal and regulatory environment and to establish a strong enforcement mechanism and clear exit policy. This included implementing a range of structural reforms such as liberalising foreign trade and investment, dismantling inefficient domestic monopolies, expanding deregulation and privatisation, and allowing greater private-sector participation in providing infrastructure.

South Korea

By early November, the contagion had spread to South Korea. The simmering turmoil in South Korea's financial markets that had begun in early January 1997 with the bankruptcy of Hanbo Steel, a large chaebol with $6bn in debts, boiled over.26 Financial troubles at Ssangyong Motors (Korea's fourth-largest car manufacturer and sixth-largest chaebol), Kia, its eighth-largest conglomerate - and other lesser chaebols, such as Hanwha and Hanjin, with combined debts of $55bn - surfaced, and foreign press reports predicted that 'South Korea could become the next Thailand'.27 During the first two weeks of November, downward pressure on the Korean won intensified, despite the Bank of Korea's repeated defence by selling dollars and widening the daily fluctuation band.28 Equity and stock prices plummeted, reflecting a lack of confidence about resolving the corporate debt burden and growing difficulties in rolling over South Korea's short-term external debt - estimated at more than $100bn, of which 70-80% were short-term liabilities, maturing within a year.29

On 17 November, South Korea finally abandoned its defence of the won, sending the currency through the psychological 1,000-to-the-dollar level. Shock waves hit the baht, the ripiah, the ringgit and other regional currencies, which fell even further relative to the dollar. Referring to the problem as a 'temporary funding shortage' and the 'idea of IMF aid as unthinkable', Seoul's new Finance and Economy Minister Lim Chang-Yuel announced that the government would form an emergency economic presidential advisory committee to solve the nation's financial problems. On 19 November, he unveiled an emergency bail-out package.30 However, seen by financial markets as too little too late, the measure failed to restore confidence. On 20 November, the won fell by another 10% to 1,139 to the dollar. Following long negotiations with the IMF, the Finance Minister reluctantly announced in a nationally televised press conference that Korea would seek emergency financial assistance from the IMF. After two weeks of tense negotiations, Michel Camdessus, IMF Managing Director, announced on 4 December that the IMF and Seoul had signed a threeyear stand-by arrangement, under which the Fund had agreed to organise a $57bn rescue package to South Korea, with funds from the IMF itself, the World Bank, and the Japanese, Western European and US governments. Seoul would receive the first payment of $5.6bn immediately, with the second tranche to follow after 18 December, following a review of Korea's adherence to the reform programme underpinning the loan.3' While President Kim Young Sam publicly conceded that 'we have lost our economic sovereignty', he nevertheless stated that his government would honour the stringent IMF conditions, and asked the nation to endure humiliating and 'bone-carving pain'.32

The Korean government agreed to a fundamental overhaul of its economy and a contractionary macro-economic policy of higher taxes, reduced spending and higher interest rates. More specifically, it agreed to: immediately suspend some 15 of the country's 30 'ailing' merchant banks with huge non-performing loans, while the surviving ones were required to submit rehabilitation plans regarding capitalisation, liquidity and management; provide more transparent financial data by requiring independent external auditors to oversee the bookkeeping practices of the Finance Ministry and the major conglomerates, including banning chaebols from making debt guarantees for affiliates, as well as forcing the government to disclose all data relating to foreign-exchange reserves, bank capitalisation and chaebol ownership in consolidated financial statements; open its financial markets by liberalising capital account transactions and increasing foreign access to domestic money-market instruments, corporate bond markets and direct investment; increase the ceiling for foreign ownership of listed shares from 26-50% by the end of 1997 and to 55% by the end of 1998; end its restrictive trade practices, including providing trade-related subsidies to promote exports and the elimination of import licensing; and - hardest for most Koreans - to raise taxes and tighten monetary policy, including facilitating labour-market restructuring by easing lay-off and dismissal restrictions under mergers, acquisitions and corporate downsizing.33

Most analysts agree that the crisis in South Korea is fundamentally a financial-sector problem, rather than a crisis of the 'real economy'. According to some, the contagion reflected nothing more than market overreaction.34 While Korea shares some of the basic underlying economic problems plaguing Thailand and Indonesia, it is structurally different. Korea is only temporarily unable to pay current foreign obligations; it is not permanently unable to earn foreign currency to repay debts. South Korean chaebols such as the top five - in overall order of size, Hyundai, Samsung, Lucky-Goldstar, Daewoo and Sunkyong - are competitive globally and benefited from the soaring yen from 1995 to mid-1996. On the eve of the crisis, the South Korean economy was performing well: real GDP grew at 8% per year through the 1980s and 1990s and its current-account deficit was slightly over 3% of GDP compared to 8% in Thailand and 10% in Mexico. Also, the bulk of foreign loans was used to finance investments in the export sector rather than property developments or imports of consumer goods - as in South-east Asia and Mexico. Finally, gross public debt amounted to only 3% of GDP, there was little inflationary pressure in the economy and, in June 1995, the country's seasonally adjusted unemployment rate stood at 2.1%, the lowest in its history.35 So why did South Korea now face a financial crisis?

A confluence of domestic and external shocks revealed fundamental weaknesses in South Korea's economy. The slow-down in international trade in semi-conductors, office automation equipment and consumer electronics severely hurt the Korean economy, which had invested heavily in this area. The 16-megabit memory chip - accounting for approximately 20% of Korean exports by mid-1995 - saw its price tumble from a high of more than $50 to under $7 by mid-1997 due to a world-wide glut, declining demand and the entrance of new competitors (Taiwan and Singapore) into the market-place.36 Since the chaebols (unlike the Japanese keiretsu) do not have their own financial institutions, they financed the construction and expansion of costly multibillion-dollar chip-fabrication factories, known as 'fabs', with massive shortterm dollar-denominated loans. They now faced impending financial disaster as the huge losses in this critical sector, compounded by weakening profitability associated with cyclical down-turns in sectors such as steel, cars, shipbuilding and labour-intensive textiles, greatly constrained the chaebols' ability to cross-subsidise their investments. Beginning with Hanbo Steel in January 1997, over a dozen highly leveraged chaebols out of the top 30, along with several poorly managed merchant banks, became bankrupt by early November 1997. Lending merchant banks, burdened with sharply rising nonperforming loans - which in mid-1997 were equivalent to 7.5% of GDP - were worst hit.37

However, many analysts have long attributed South Korea's phenomenal export-led economic modernisation that began in early 1960 under the Park Chong Hee regime to the collaborative relationship or 'pragmatic synergy' between a highly centralised, interventionist 'developmental state' and the large private conglomerates known as chaebols it created.38 Endowing itself with exclusive authority over the coordination of fiscal, monetary and trade policies, South Korea's 'administrative state' kept a watchful eye over the chaebols, while nurturing them with generous subsidies and protection from competition in return for utilitarian performance standards. The state-chaebol alliance became indispensable to South Korean development. Working together, they were seen as formidable partners, with an uncanny ability to follow market signals, preemptively respond to externalities and broker relations with foreign investors and creditors. Why, then, is the state-chaebol alliance, the symbol of South Korea and the East Asian development model, now at the root of South Korea's financial crisis?

In retrospect, the merits of this alliance were grossly overstated. While the system aided Korea's ambitious early drive to export-led industrialisation, by the early 1980s it had become corrupt. As noted earlier, since Korea's strong developmental state enjoyed substantial powers over resource allocation, and the chaebols depended on the state to provide them with low-interest credit, subsidies, preferential tax breaks and government approvals to function and expand their many operations, relations gradually degenerated into an alliance based on Confucian piety, patronage, nepotism and widespread corruption. The result was the loss of coherent and judicious economic management. The recent cases against two former Presidents - Chun Doo Hwan (1981-87) and Roh Tae Woo (1988-92) - revealed unprecedented levels of racketeering, extortion and self-aggrandisement as politicians and political parties collected large sums of money from the chaebols in return for easy credit, loan guarantees, protection from global competition and other privileges.39

People hoped that Kim Young Sam's election as President in December 1992 (the first directly elected civilian head of state for over 30 years) would reform the old networks and corrupt state-chaebol nexus. Kim had made financial deregulation and clean government a priority during his election campaign. However, during its five-year term, his government introduced only limited measures that had the paradoxical effect of further entrenching and changing the state-chaebol-private sector triangle. Under the new Kim government's financial-liberalisation programme, patronage-dispensing politicians and chaebols, in the name of further solidifying the country's bid for Organisation for Economic Cooperation and Development (OECD) membership, and transforming South Korea into a world-class industrial and technological power, were able to borrow huge sums from banks and financial institutions without any constraints or caution.

While careful not to repeat the Mexican government's costly mistake of luring foreign capital by issuing short-term and high-yielding dollar-indexed bonds, Seoul made a different, but equally costly, error. Its new financialliberalisation policy gave a free hand to the chaebols and commercial and merchant banks to borrow large sums of money, without supervision, from both domestic depositors and abroad. What followed was an orgy of imprudent borrowing - mostly unhedged short-term dollar-denominated loans from eager international banks (primarily European, Japanese and US), totalling over $70bn. This sum was then ploughed into expanding the capacities and performance of chaebol industries such as automobiles, shipbuilding, telecommunications, electronics, petrochemicals, aeronautics, steel and semi-conductors, and also into over-inflated construction and property projects, including lucrative in-built kick-back schemes for influential politicians, among them the President's son.40 Moreover, the absence of proper coordination of investment decisions (as each claebol tried to out-do the other), coupled with the virtual abdication of prudential regulation and supervision of the chaebol and banking-sector dealings, resulted in excessive capacity-creation in almost all sectors.

The problem was compounded in late 1996, and especially in early 1997, with the sharp drop in export prices and loss of market share. By permitting leverage (the ratio of debt to equity) to rise to levels that could only be sustained with continued rapid growth, the conglomerates could no longer meet their debt obligations. As a consequence, they faced bankruptcy; banks and other creditors with billions of dollars of non-performing loans (estimated to be over $33bn) faced insolvency." Compounding this problem was the rapid build-up of the short-term dollar-denominated external debt totalling $100bn, with $40bn due by the end of March 1998, and the remainder by the end of 1998. The sustained appreciation of the zoon - and the fact that the debts borrowed in dollars and to be repaid in dollars doubled over time - led some to conclude that South Korea's real foreign debt is over $150bn.42 Faced with such daunting financial problems, the old certitudes crumbled. South Korea swallowed its pride and turned to the IMF for assistance.

The IMF: Saviour or Villain?

Asia's financial crisis has dragged the IMF into the global spotlight, subjecting it to intense public scrutiny and sometimes scathing criticism. While some criticism is valid, much is disingenuous or based on a lack of understanding of the Fund's role and its mandate.

Under the institution's Articles of Agreement, the 182 member-countries and ignatories to the charter have committed themselves to promoting global trade and deepening economic integration by maintaining a stable international monetary system. This goal is to be achieved by allowing individual national currencies to be exchanged for foreign currencies in the market-place without restriction (currently only 117 members have agreed to the full convertibility of their currencies). Member-countries are obligated to keep the IMF informed of any changes in their financial and monetary policies that may adversely affect fellow members' economies, and to modify or reform national policies on the IMF's advice promptly to facilitate international trade. The Fund serves as a credit union for its members and manages their common pool of financial resources - estimated to be over $215bn in 1997. It is also a vehicle to establish a stable value for each currency.43 The Fund's capital comes almost entirely from 'quota subscriptions' or membership fees, assessed on the basis of each member's economic size. Hence the US - the world's largest economy contributed about 18% (approximately $38bn in 1997) of the total quota, followed by Japan and Germany, which contributed 5.67% (or $12bn) each. Quotas are reviewed every five years, allowing members to alter their contributions. The size of quotas determine a member's voting power; a larger quota allows it to borrow more in time of need.

Contrary to popular perception, the IMF cannot decide or dictate which economic policies its members should pursue. Its powers of compulsion only come into effect once a member-country formally seeks its assistance, and then it can use that assistance as leverage. The Fund is an advisory body that can only exert moral pressure and encourage members to respect the rules and regulations they have agreed to observe. After Mexico's peso crisis, its members invested the IMF with greater authority by strengthening its powers of 'surveillance'. This move enables the Fund to scrutinise its members' financial and banking systems more closely, and to monitor and review their monetaryexchange policies to ensure that they meet transparency requirements. When necessary, the Fund provides members with expert technical and operational assistance in designing macro-economic policies and in setting up agencies to collect and publish economic data. However, its surveillance is carried out through annual consultations with senior Finance Ministry officials in the member-country, and by independently reviewing the official data on exports and imports, wages, prices, employment rates, interest rates, investments, tax revenues, budgetary expenditures and other variables that affect the relative or exchange value of currencies. The results of these reviews are published biannually in the IMF's World Economic Outlook, and in the annual International Capital Markets report.

If the IMF is provided with accurate and extensive economic data, its supervision can provide an early-warning system or an opportunity to spot any potential exchange-rate or balance-of-payments problems. Since it has no effective authority over the domestic macro-economic policies of its members, each member can accept or decline the IMF's suggestions.

While members have the right to borrow from the Fund, in practice it only lends to those facing a balance-of-payments problem. If the member borrows more than the initial 25% of its quota, it must, under the Articles of Agreement, fully disclose information on its monetary and fiscal policies and demonstrate to the IMF's 24 Executive Directors how it intends to resolve the underlying fiscal problem.44 Only when the Executive Directors are satisfied can the IMF disburse loans in instalments - usually under the 'stand-by' or 'extended' arrangement system.45 The Fund is also authorised to provide members with additional liquidity by issuing special drawing rights (SDRs), a fiduciary asset that can be retained by members as part of their monetary reserves or used in place of national currencies in transactions with other members.46

The IMF is thus not an imperious leviathan, arbitrarily making rules and dictating economic policies to its members. Rather, it acts as an intermediary between the majority will of the membership and the individual member.

The IMF in Asia

First, the criticism that the Fund failed to anticipate the crisis is untenable. As discussed above, the IMF's early-warning system did work. It not only foresaw the crisis in mid-1995, but senior IMF officials continually warned governments that the combination of pegged exchange rates, poor bank supervision and the build-up of short-term unhedged debt could prove disastrous. The IMF told Thailand and Indonesia that they may not be able to sustain large currentaccount deficits over the long term, and suggested that they reduce trade deficits to minimise the risk of serious balance-of-payments problems in future. What the IMF did not anticipate was the magnitude of the crisis, nor when it was likely to occur. The latter task is impossible, and the former proved difficult, given the lack of transparency, lax banking regulations and the patrimonial corporate culture and business practices in these countries. But this also begs the question: since it is the Fund's task to monitor financial transparency, did it fail in its responsibility? As noted earlier, surveillance is based on consultation and collaboration between the IMF and its members. In hindsight, while the Fund should have scrutinised the high-performing Asian economies and demanded greater transparency, there were obvious limits to what it could do. Member-governments not only ignored warning signs, they also failed to provide timely and reliable data. For example, there was inadequate data on external debt and official reserves with regard to forward obligations, swaps, including other liabilities, and the usability of reserves. This prevented the Fund from analysing the problem more thoroughly and proposing a possible recovery plan. The reluctance of Asian governments to tighten monetary policy and to close insolvent financial institutions heightened financial meltdown. Moreover, Asia's financial problems are based largely on misallocated investment, unhedged short-term borrowing and, in South Korea, a very high debt-to-equity ratio rooted in the poorly regulated financial markets in the private sector. They are thus beyond the IMF's purview.

Second, critics such as the Harvard economists Jeffrey Sachs and Martin F. Feldstein have repeatedly asserted that the IMF's unimaginative prescriptions have `made Asia's financial turmoil worse'.47 According to Sachs, while the weaknesses in the Asian economies were significant, they were 'far from fatal'. However, the Fund's overdose of bitter medicine - notably pressing governments to raise the existing budget surpluses still higher and to tighten domestic bank credit by increasing interest rates, including the imprudent closing down of several weak banks - prolonged asset-price deflation in property and further eroded investor confidence. This resulted in the 'stampede mentality', the subsequent capital flight and further economic contraction.

While the IMF has admitted that it erred in requiring Jakarta to implement tough budget-tightening measures, it nevertheless claims that the rest of its reform prescriptions are `basically sound', not only for Indonesia, but also for Thailand and South Korea." Moreover, the Fund can legitimately claim that it has been flexible in implementing its reform prescriptions. For example, in January 1998, Thai Prime Minister Chuan Leekpai asked the IMF to ease the terms of its $17.2bn bail-out package, since it was impossible for Thailand to produce a budget surplus given that the baht had lost half its value. Similarly, Finance Minister Tarrin Nimmanahaeminda formally requested in late January 1998 that the IMF ease its requirement that Thailand produce a cash surplus equal to 1% of its GDP in the fiscal year ending in September 1998. Fully acknowledging that its projection of the baht stabilising at about 32 to the dollar (it stood at 51.05) was based on `optimistic assumptions', and following the Fund's second quarterly review in early February 1998 (which praised the Thai government's adherence to reform), the Fund adjusted the required growth for 1998 to zero to 1.Q%, from 3.5%.

While the IMF failed to arrest the currency decline, the argument that its prescriptions contributed to the sharp fall in regional currencies is not convincing. The baht's decline had more to do with the erratic nature of investor confidence and spreading regional contagion than the Fund's financial reform and austerity measures. Malaysia - not under any IMF assistance programme - saw the ringgit drop to a historic low of 4.06 against the dollar after new figures from the Bank of International Settlement (BIS) revealed that Malaysia's short-term debt was actually 56% of total borrowing from foreign banks, not the earlier 30% estimate." Similarly, the rupiah's wild swings - from 2,400 to the dollar in July 1997 to 6,750 on 5 January 1998 and 9,500 on 8 January - was a sweeping indictment by the market following Suharto tabling an expansionary and unrealistic 1998-99 national budget on 6 January. The budget, a complete abrogation of what the Suharto regime had negotiated and signed under the IMF's 5 November stand-by and subsequent stabilisation agreements, totalling some $43bn in loan guarantees, failed to shore up the banking system, curb inflation, cut costly high-profile government projects and dismantle inefficient and profligate monopolies with close links to the Suharto family's vast financial empire. It was only after Suharto reluctantly signed the letter of intent with the IMF on 15 January and agreed to abide by the terms of the agreement that a measure of financial stability was restored, and the rupiah 'stabilised' at 8,200 to the dollar. However, five days later, it plunged to the 9,500 mark, nose-diving to 12,000 on 21 January, and an all-time low of 17,100 on 23 January before 'recovering' to 11,400 on 27 January. But the rupiah's rapid downward spiral was not a reflection of the Fund's misguided policies - the markets were responding negatively to the discretionary delays by Suharto to implement the IMF programmes, and his blatant act of defiance in choosing his long-time friend and big-spending Technology Minister, B. J. Habibie, as his Vice-Presidential candidate (and presumed successor) in the March polls. The markets rightly concurred with the IMF and the Clinton administration's view that Habibie - who has a major financial stake in almost every business activity in Indonesia - epitomises the crony capitalism and perverse business subculture responsible for the crisis. Moreover, as a critic of the IMF and so-called 'foreign interests', Habibie would simply rubber-stamp, if not promote, Suharto's pattern of half-measures on the agreed IMF reforms."

Perhaps nothing reveals the Suharto regime's obduracy more than its plans in early 1998 to create a fixed exchange-rate system for the volatile ripiah through a currency board in direct opposition to the IMF, the US, the European Community, Japan and other donor governments. While rumours that Indonesia may adopt a currency board had been circulating for weeks, by midFebruary 1998, Jakarta began to send implicit messages that it would unilaterally establish such a board, unless the Fund devised a better alternative for strengthening the ripiah..51Following the appointment on 17 February of US-trained economist Sjahril Sabirin as the new Bank Indonesia Governor, the Indonesian government embarked on a media blitz to promote its currencyboard regime.52 Jakarta's strategy seemed to have worked. Several prominent academics, including Sachs and Steve Hanke, claimed that, unlike an ordinary exchange-rate peg, the predictability and rule-based nature of a currency board would impose strict discipline on profligate governments, preventing them, for example, from abusing the Central Bank's printing presses to fund large deficits. Using the example of the Hong Kong dollar (which has been officially fixed at HK$7.80 to the dollar since its currency board was introduced in 1983), and has weathered the crisis reasonably well, supporters argued that, since the currency board holds extremely low-risk interest-bearing bonds and other assets denominated in the anchor currency, it not only encourages arbitrage, but also offers an effective barrier against speculative attacks and rapid currency appreciations - or tends to keep interest rates and inflation in the currency board country roughly on a par with those in the anchor-currency country. Moreover, some claim that currency boards provide stability to the banking and financial system by maintaining market-adjusted interest rates and prudentially controlling destabilising international capital flows.

The IMF is not, in principle, necessarily opposed to emerging economies establishing currency boards. It strongly opposed Indonesia's plan because it felt it was a 'quick fix' and ultimately unsustainable. The Fund argued that Indonesia should implement the agreed reforms before establishing a currency board. Since such a board must hold reserves of foreign exchange (or gold or some other liquid asset) equal at the fixed rate of exchange to at least 100% of the domestic currency issued, the IMF concluded that Indonesia's $17bn in disclosed foreign-exchange reserves was inadequate to back the estimated 24tr rupiah in circulation - draining the reserves in a few weeks.53 It also feared that the Suharto regime would dip into the IMF loans to support the currency board, and found the Hong Kong example to be spurious, since Hong Kong unlike Indonesia - has formidable foreign reserves totalling over $85bn to cover the currency in circulation plus demand deposits, and well-regulated and capitalised banks able to cope with the high interest rates that might be needed to defend the currency board. Finally, with good reason, the Fund remained highly suspicious of the 'Suharto plan', under which the rupiah's rate would be 5,000 to the dollar, or about twice as strong as the current rate. Privately, senior Fund officials felt that the currency board was a ploy to allow Suharto's children and cronies to retrench their discretionary rent-seeking structures and change their substantial rupiah holdings into dollars at an artificially high rate before moving funds into offshore accounts.

Third, Sachs is partly correct in noting that lower interest rates would ease access to credit and keep more companies and jobs afloat. However, prudence indicates that, under conditions when market confidence has yet to be reestablished, capital outflows persist and currencies continue to depreciate, high real interest rates on a short-term basis are necessary. In other words, relaxing monetary policy would only lead to further currency depreciations. Hence, high interest rates are required to attract foreign investment, keep currency speculators at bay and inflation under control and to provide incentives for the corporate sector to restructure its financing away from debt and towards equity. Furthermore, without the security of higher interest rates, it was theoretically possible for the weak currencies to free-fall, increasing the debt burden in domestic currency and severely hurting borrowers who must pay off their foreign-currency obligations. The Fund also had little choice but to close down insolvent banks, including at least one controlled by Suharto's sons, Bambang Trihatmodjo and Hutomo 'Tommy' Mandala. However, contrary to what the critics suggest, the closures were not arbitrary. A number of weak but viable banks were allowed to operate once their rehabilitation plans were approved by the national Central Banks and the Fund. Shareholders of the closed banks will not be compensated; small depositors have been compensated by the Indonesian government.

Finally, Sachs and other critics have argued that the Fund's massive financial rescue packages, beginning with that extended to Mexico in 1995, have exacerbated 'moral hazard'. Moral hazard is a situation where someone can reap the rewards from their actions when things go well, but does not suffer the consequences when things go badly. Hence investors do not have to exercise due diligence, since they would expect a bail-out in the case of default. Debtor countries can choose to pursue risky economic policies knowing that they will not have to pay the full costs of their debts and investors will not lose the full amount invested if a financial crisis occurs. In Asia, by cushioning the losses of imprudent lenders and borrowers with generous bail-out packages, the IMF encourages reckless behaviour. While the logic of this argument is irrefutable, it is difficult to measure the degree of moral hazard in any given situation, and the effect on moral hazard of providing financial assistance in a crisis. After all, what looks like moral hazard may be lenders and investors simply misreading the markets and making bad decisions. Also, the IMF's shareholders, its 182 members, recognised that the Fund had little choice but to intervene in a sovereign financial crisis to contain and/or minimise the spread of a global systemic financial crisis, thereby creating the potential for 'moral hazard'. Moreover, the fact that equity prices have plunged by 30-50% since the crisis began has meant that equity investors and owners of other publicly traded instruments have experienced significant losses in the value of their investments, while international banks have recorded losses, especially against their exposure to corporations.54 Also, there are no provisions in IMFsupported programmes for public-sector guarantees, subsidies or support for non-financial institutions; no special treatment is provided for institutions' shareholders who have lost their capital. According to US Federal Reserve Chairman Alan Greenspan:

Asian equity losses, excluding Japan, since June 1977 world-wide are estimated to have exceeded $700bn, of which more than $30bn has been lost by US investors. Substantial further losses have been recorded in bonds and property.55

Conclusions

Suharto, who enjoys personalised and discretionary control over much of Indonesian public life, was unanimously re-elected by a largely appointed People's Consultative Assembly to a seventh term as President on 10 March 1998.56 Normally, this act would go largely unnoticed, but this time Suharto used the occasion to declare that the IMF reforms would be abandoned since they violate Indonesia's Constitution. The IMF and donor governments responded by withholding their $3bn aid tranche, and postponing review of the aid package until mid-April. Caught in this brinkmanship game, the rupiah fell past the 10,000-to-the-dollar level, and total foreign debts climbed to over $166bn. Reluctant to challenge the privileges of his family, cronies and traditional constituencies, Suharto's vast and ethnically varied archipelago empire faces an uncertain future.

While the evidence remains partial, most analysts nevertheless agree that the IMF's bitter medicine is gradually resuscitating its two sickest patients Thailand and South Korea. Bangkok's adherence to the IMF prescriptions is starting to pay dividends. The IMF's vote of confidence not only contributed to a stock-market rally in late January; several major European, Japanese and US banks agreed to roll over their debts for several of Thailand's stronger privatesector banks and financial companies. Fears of a debt moratorium have receded with an improvement in Thailand's current account - it recorded a surplus of $800m for the last three months of 1997, and is expected to reach over $18bn in 1998.57 Similarly, it was the confidence generated by the $60bn IMF package and the Kim Dae Jung administration's commitment to reform that helped the Korean won recover nearly one-third of its value against the dollar by midJanuary 1998. The IMF's gentle pressure, combined with more aggressive prodding by the US Federal Reserve and the Bank of Japan, that prompted several major foreign banks to reschedule the servicing of some $24bn in shortterm debts by converting bank debts into more manageable government-issued bonds with flexible maturities. The threat of a national debt moratorium has also receded in South Korea.

IMF critics are correct on one score: the ailing Asian tigers have the wherewithal to recover. Their secrets of success - high savings, prudent investment in education, relatively egalitarian distribution of income, low taxation and a market-guided commitment to export promotion - are all still present. Before the crash, these would have been seen as sufficient conditions for the sick tigers to make a quick recovery, but not any longer. The demands of the emerging global economy require deeper market integration, rigorous economic transparency and effective management. The crisis has also exploded the myth about the merits of 'developmental dictatorships'. The record of Thailand's austere Chuan Leekpai and South Korea's Kim Dae Jung - former political prisoner, dissident, human-rights activist and now President illustrates that democratic and accountable government, based on the rule of law, is an important first condition for Asia's recovery.

On 8 April 1998, in what is their third agreement in six months, the Indonesian government and the

IMF signed a new 'memorandum of understanding'. It is yet another effort to get Indonesia to comply with the IMF conditions before the second tranche of $3bn can be released. In an effort to assure compliance, the IMF Executive Board, along with the World Bank and the ADB, will carry out joint `daily monitoring'. The tranche is to be released gradually, and only after Indonesia undertakes substantive reforms.58 Although the new agreement reiterates many of the IMF'S earlier prescriptions, under the new terms, both parties have made important concessions. The IMF has agreed to allow Jakarta to continue subsidising the import of food, fuel and feedmeal for livestock until October 1998, including preferential exchange rates for the private firms helping to distribute these commodities. The Indonesian government has agreed to accelerate bank restructuring by closing all insolvent banks, tightening money supply, and developing a comprehensive arrangement with foreign creditors to restore trade financing and to resolve the problem of interbank credit and corporate debt. Only time will tell if Suharto lives up to his end of the bargain.

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Notes

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1 South Korea's inclusion was a surprise: its economy was performing well, growing by 9% for much of the 1990s, with employment at an all-time low of 2.1%. Korea was not only the major beneficiary of the soaring Japanese yen; South Korean firms were also becoming major investors in China and South-east Asia.

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2 Since these countries relied heavily on inflows of private capital, the IMF had only limited influence over them. However, several senior Thai and Indonesian policy-makers told me that the IMF failed to give them adequate information or advance warning. 3 Elected in July 1995 after the fall of the Chuan Leekpai government, the sevenparty coalition government headed by Prime Minister Banharn Silpa-archa was viewed as a 'lame-duck' administration from the outset. Banharn's Chart Thai Party, widely seen as the chief culprit in Thailand's complex vote-buying system,

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was too preoccupied with domestic issues to heed the IMF's warning. The fact that Banharn appointed a Finance Minister with little experience, and two Vice-Ministers accused of malfeasance, inspired little confidence in his administration. See Suchit Bunbongkarn, Thailand: State of the Nation (Singapore: Institute of Southeast Asian Studies, 1996).

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4 Thailand has experienced several periods of economic instability in the past three decades. During the early 1980s, the government responded effectively to fiscal imbalances and external oil shocks. Its structural adjustment package - fiscal retrenchment, improved exchange-rate management and export stabilisation was deemed a success. See Peter G. Warr and Bhanupong Nidhiprabha, Thailand's Economic Miracle: Stable Adjustment and Sustained Growth (Washington DC: World Bank, 1996). On the Mexican crisis, most Asian developing-country currencies came under attack in mid-January 1995, requiring intervention and defensive interest-rate increases. The Thai baht was most severely affected because traders had built up large positions in the domestic money market to arbitrage the baht's peg against the basket of the dollar, yen and Deutsche Mark. While the government successfully defended

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the baht by holding the peg, Thai foreign reserves fell by $400m. Securities markets in some Asian countries also dropped sharply. In Hong Kong and Singapore, stock-markets fell by about 9%, while from 18-24 January, equity prices in Indonesia, Malaysia and Thailand fell by about 10%. On Thailand's bullishness, even knowledgeable individuals such as Bandid Nijathaworn, Deputy Director of the Bank of Thailand's economic research department, ignored Thailand's 10 billion-baht balance-of-payments deficit in the first quarter of 1995, when he stated that the current-account deficit would shrink rapidly as investment reached its cyclical peak and started to slow down. See 'Thailand', Asia 1996 Yearbook (Hong Kong: Far Eastern Economic Review, 1997), pp. 217-18.

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5 See Financial Times, 29 August 1997. 6 The Central Bank imposed credit controls on housing purchases, reducing financing from 90% of purchase prices to 60%. This action was followed by the government's budget, which increased property gains tax from 20-30% and placed a $37,735 levy on foreign purchases of property. 7 But the Bank actively bought the ringgit to prevent it from reaching 2.25 to the US dollar, seen as a 'psychological barrier' for much of 1996. 8 See IMF, World Economic Outlook: An Interim Assessment - December 1997 (Washington DC: IMF Publications, 1998). 9 Ibid; and the World Bank, The East Asian Miracle: Economic Growth and Public Policy (New York: Oxford University Press, 1993). 10 See The WTO Annual Report: 1997 (Lausanne:

WTO SecretariatInformation and Media Relations Department, 1997). " See the World Bank, The East Asian Miracle. 12 Bestsellers included John Naisbitt,

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Megatrends Asia (New York: Simon and Schuster, 1996); and Jim Rohwer, Asia Rising: Why America will Prosper as Asia's Economies Boom (New York: Simon and Schuster, 1995). 13 Jagdish Bhagwati, 'The Feuds over Free Trade', paper presented at the Institute for South-east Asian Studies, Singapore, 18 September 1996; and Linda Lim, 'South-east Asia: Success Through International Openness', in Barbara Stallings (ed.), Global Change, Regional Response (New York: Cambridge University Press, 1995). 14 The only dissenter to the Asianmiracle thesis was the economist Paul Krugman. In a provocative article, he argued that Asian growth could be explained by basic economic factors such as high savings rates, investment in education and job creation - growth in output, the result of working harder, not smarter. However, Krugman's model predicted 'diminishing returns' or a gradual loss of economic momentum, not a crash. See Krugman, 'The Myth of Asia's Miracle', Foreign Affairs, vol. 73, no. 6, November-December 1994.

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15 For details, see IMF, International Capital Markets: Development Prospects and Policy Issues (Washington DC: IMF and World Bank, 1995); and Private Capital Flows to Developing Countries: The Road to Financial Integration (Washington DC: World Bank, 1995). 16 For example, Malaysia reported a total capital inflow equivalent to 20% of its GDP in 1994, while Thailand's external capital inflow peaked at 12.5% of GDP in 1995, with some 95% of these inflows consisting of portfolio and equity placements. The 1993 and 1996 data is from the World Bank, Global Economic Prospects and the Developing Countries (Washington DC: World Bank, 1996), pp. 11-2. 17 The gross foreign liabilities of commercial banks have expanded rapidly in many capital-importing

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countries. In Malaysia, foreign liabilities as a percentage of GDP increased from 7-19% during 1990-93. In Indonesia, banks' external liabilities increased from 2% of GDP in 1989 to 6% the following year. The same ratio increased from 8% in 1991 to 13% in 1994. In Thailand it increased from 4-20% from 1988-94. " By the end of May 1997, finance companies had liabilities of 1.39 trillion baht, outstanding foreign loans worth 1 ll baht, and outstanding promissory notes worth 912bn baht. Also, about 12% of bank loans and 20% of financecompany loans were non-performing, involving a total of about ltr baht or 20% of GDP. See the Economist Intelligence Unit (EIU), Country Report: Thailand, Third Quarter 1997, p. 22.

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19 Unlike this basket of currencies, the managed float system meant the baht's value would be set by market forces. 20 From 20-23 October 1997, the Hong Kong stock-market suffered heavy losses, shedding nearly a quarter of its value in four days because of fears over interest-rate increases and pressure on the Hong Kong dollar. The drop was more severe than the 1987 crash, forcing the Hang Seng index 23.34% down on 23 October. 21 For details, see 'Japan to the Rescue', The Economist, 11 October 1997, pp. 8990.

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22 Japan's premier EXIM Bank pledged special drawing rights of 3bn ($4bn), the largest sum it has ever lent. 23 The reassuring words of Malaysia's Deputy Prime Minister and Finance Minister Anwar Ibrahim finally calmed the markets. For remarks, see Far Eastern Economic Review, 2 October 1997, p. 70; 'South-East Asia in Denial', The Economist, 18 October 1997, pp. 14, 3940; and 'Indonesia: No Thanks IMF', ibid., 1 November 1997, pp. 43-44. 24 For a good overview, see Martin Wolf, Financial Times, 9 October 1997. 25 For details, see IMF Press Release no.

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97/50, 'IMF Approves Stand-By Credit for Indonesia', 5 November 1997, available at www.imf.org. 26 Created by Park Chung Hee's regime (1963-79), chaebols are conglomerates of many companies grouped around one holding or parent company. The parent company is usually controlled by one family. In 1988, the 40 top chaebols owned 671 separate companies. The four top 'super-chaebols' have sales accounting for 40-45% of South Korea's GDP. However, chaebols do not own or control financial institutions (since South Korean banks were nationalised until the mid-1970s), making them highly dependent on government policies and predilections. For more detail, see Lee Jay Cho and Yoon Hyung Kim (eds), Economic Development in the Republic of Korea: A Policy Perspective (Honolulu, HI: University of Hawaii Press, 1991); and Laxmi Nakarmi, 'What Now For The Chaebol', Asiaweek, 19 December 1997.

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27 See Nicholas Kristof, 'Troubled Economy Stirs Fears in South Korea', New York Times, 10 November 1997. 28 Unlike the other South-east Asian currencies, the Korean won is not pegged to any currency. In early November 1997, the government allowed its value to fluctuate by up to 10% per day to revive the foreign-exchange market and draw dollar deposits. Despite widening the fluctuation band, the won continued to fall throughout 1997. 29 For details, see 'IMF Accelerates Disbursement to Korea', IMF Survey, vol. 27, no. 1,12 January 1998. 30 Chang-Yuel replaced Kang Kyongshik, who had resigned after taking responsibility for the crisis. See Kristof, 'Seoul Plans to Ask the IMF for a Minimum of $20bn', New York Times, 22 November 1997, p. B2. 31 Nicholas Kristof, 'Package of Loans Worth $55 Billion Set for South Korea', ibid., 4 December 1997, p. C6. 32 Kim Young Sam quoted in Kristof,

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'Seoul Plans to Ask', p. B2. All three political parties and presidential candidates - Rhee In Je, Lee Hoi Chang and Kim Dae Jung - all finally acceded to the IMF's demands. Kim Dae Jung was elected president for a five-year term on 18 December 1997. 33 For details, see IMF Press Release no. 97/55, 'IMF Approves SDR 15.5 Billion Stand-By Credit for Korea', 4 December 1997, available at www.imf.org. I See Jeffrey Sachs, 'International Monetary Failure', Time (Asia issue), vol. 150, no. 23, 8 December 1997. 35 Data drawn from Asia 1996 Yearbook, pp. 151-55; and IMF, World Economic Outlook.

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36 See 'Semiconductors: Chips on their Shoulders', The Economist, 1 November 1997, p. 62.

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37 IMF Press Release no. 97/55, 'IMF Approves SDR', available at www. imf.org. 38 There is a vast body of literature on this relationship. The more sophisticated studies include Alice Amsden, Asia's Next Giant: South Korea and Late Industrialization (New York: Oxford University Press, 1989); and Robert Wade, Governing the Market: Economic Theory and the Role of Government in East Asian Industrialization (Princeton, NJ: Princeton University Press, 1990). 39 Chun Doo Hwan had received over $900m and Roh Tae Woo about $600m. In a TV appearance, a tearful Woo confessed that he had over 170m won in political slush funds for

personal use. Roh admitted that among his many generous donors were the heads of some of South Korea's largest chaebols, including Samsung Group chairman Lee Kun Hee and Daewoo boss Kim Woo Choong. 40 As the collapse of the Hanbo chaebol unfolded, a huge scandal involving the President's son was uncovered. Later investigation suggested that the President himself may have been

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involved. 41 See Laxmi Nakarmi, 'What Now For The Chaebol', Asiaweek, 19 December 1997. 42 See C. P. Chandrasekhar, 'A Package of Problems , Frontline, vol. 15, no. 1,1023 January 1998. 43 Taking into account that 75% of country-quota subscriptions are in domestic currency, and that approximately half of the money on the IMF balance sheet cannot be used (because it is kept as reserves), its funds of $215bn are relatively modest. 44 At present, eight Executive Directors represent individual countries - China, France, Germany, Japan, Russia, Saudi Arabia, the UK and the US. The 16 other Executive Directors represent groupings of the remaining countries.

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45 'Stand-by' arrangements are 1-2-year support programmes designed to correct short-term balance-of-payments problems, while the extended arrangements (usually limited to 3-4 years), are designed to allow countries to reorganise their financial and monetary system. I An artificial value, based on the average worth of the world's five major currencies (the US dollar, German Mark, UK sterling, French franc and the Japanese yen), is assigned to the SDR. Currently there are 21.4bn SDRs in existence, worth approximately $29bn, accounting for about 2% of all reserves. 47 Jeffrey Sachs, 'The Wrong Medicine for Asia', New York Times, 3 November 1997; and Martin Feldstein, 'Refocusing the IMF', Foreign Affairs, vol. 77, no. 2, March-April 1998. 48 See IMF News Brief no. 98/2, 'Indonesia Standby Agreement: Review Under the Emergency Financing Procedures', 7 January 1998, available at www.imf.org. 49 Set up in 1930, the BIS started out as an exclusive club of mostly Western Central Banks. It has operated as a

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clearing house for the foreign reserves of many countries and as a lender of shortterms loans. Since 1996, BIS membership has expanded from 32 to include nine more monetary authorities in Asia, Latin America and Europe. Owned and controlled by the member Central Banks, the BIS provides them with data on capital flows and sets recommended regulatory standards, such as capitaladequacy levels.

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50 It was the quick implementation by Bank Indonesia Governor Soedradjat Djiwandono of key IMF prescriptions, including the elimination of all restrictions on overseas ownership of Indonesian banks, that enabled the rupiah to rally to 7,450 to the dollar on 10 February 1998. However, as one of the few reformers in the Suharto regime, Djiwandono was increasingly isolated. Suharto dismissed him on 17 February, after the Governor 'had argued that Suharto was about to subvert an economic recovery plan he reluctantly signed just last month with the IMF'. See David Sanger, 'Risking IMF Aid, Suharto Dismisses Central Banker', New York Times, 18 February 1998. 51 See Peter Passell, 'Economic Scene: In Indonesia, Slowdown on a Risky Bet', ibid., 19 February 1998. 52 See 'Asian Currencies: Going by the

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Board', The Economist, 14 February 1998, pp. 775. 53 Jose Manuel Tesoro, 'A Quick Fix? Maybe Not', Asiaweek, 6 March 1998. ' As of December 1997, Korea's stockmarket had declined by 67% since 11 August, Indonesia's had declined 75% since 30 July, and Thailand's stockmarket had declined 63% since 29 July. See IMF, 'IMF Bail Outs: Truth and Fiction', January 1998, available at www.imf.or .

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55 Transcript of 'Testimony of Chairman Alan Greenspan Before the Committee on Banking and Financial Services', US House of Representatives, Washington DC, 30 January 1998. 56 The People's Consultative Assembly, which incorporates the House of Representatives, has 1,000 members, of which 575 are directly appointed by Suharto and the other 425 indirectly. 57 This improvement in Thailand's current account is largely the result of import suppression, rather than revenue growth. For details, see Michael Vatikiotis, 'Bailout Blues', Far Eastern Economic Review, 19 February 1998. 58 For details, see David Sanger, 'Indonesia, IMF Reach Latest Economic Agreement', New York Times, 8 April 1998; and Assif Shameen, 'Once More with Feeling: Indonesia and the IMF Try Try, Try Again', Asiaweek, 17 April 1998.

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